1

THE MEANING AND THE STRATEGY OF ECONOMIC DEVELOPMENT

This book, which deals with the fiscal and monetary policies of developing countries, can be said to fall largely within the sphere of what has come to be known as 'normative' economics. Although this is not universally acknowledged, any work concerned with issues of economic policy must inevitably embody certain value judgments, whether or not expressly stated, derived from the moral and political philosophy of the author. These value judgments are generally reflected in the basic assumptions underlying the analysis of policies and often influence the theoretical framework of the analysis. Because of this, we believe that the reader is entitled to be informed in advance of the more important value judgments contained in the book, and this introductory chapter is devoted largely to that purpose.

We first explain what is understood here by the concept of 'economic development' and consider the difficult question of measurement of the rate, or pace, of economic development. We then set out what we regard as important reasons for government intervention and participation in the process of economic development. Lastly, we draw attention to the key role which, in our view, is played by institutional and political factors in determining the course of economic development – a thesis frequently invoked in the monograph.

THE MEANING AND MEASUREMENT OF ECONOMIC DEVELOPMENT

There is no simple definition of 'economic development' which adequately reflects the experience of the countries which are undergoing development.[1] Economic development is a very complex process

1. For a discussion of the meaning of economic development, see Gerald M. Meier, *Leading Issues in Economic Development*, second edition, OUP (1970), pp. 5–9. See also Frances Stewart and Paul Streeten, 'New Strategies for Development: Poverty, Income Distribution and Growth', *Oxford Economic Papers*, November 1976.

involving not only economic, but also many social, political, technological and cultural changes. For the purpose of this book, however, one need not provide a comprehensive definition embracing all the important features of development. It would generally be agreed that the primary purpose of seeking development of a country is to increase the economic welfare of its inhabitants by mobilising its productive resources. One could, therefore, define economic development, somewhat narrowly, as the process of increasing the degree of utilisation and improving the productivity of the available resources of a country which leads to an increase of the economic welfare of the community by stimulating the growth of national income.

It follows from the above definition that the progress of development has to be assessed by reference to two separate indicators, namely, the indices of 'production', or 'national income', and of the 'economic welfare' of the community. The former covers what may be designated as the 'growth' aspect of development. The economic welfare indicator, on the other hand, brings to light, as we shall presently see, the pattern of allocation of resources and of the distribution of income among different groups and classes of the community; in a sense, it combines the 'quality' and the 'growth' aspects of development.

The most common index of development used in economic literature is that of growth in per capita GNP at constant prices, or per capita real income. This index, however, covers only the 'growth' aspect of development; it takes no account of the distribution of income. As an indicator of the increase in the economic welfare of the community as a whole, it is adequate only for a homogeneous society whose members all benefit equally from a rise in national income; it is clear that such societies do not exist.[2] Nevertheless, the index is widely used and this is usually justified on the grounds that individuals' utility, or welfare, is unmeasurable and that there is no 'objective' or 'scientific' way of numerically quantifying changes in the welfare of the community that may result from a redistribution of income among its members. Following Pareto, an 'optimum' welfare situation for a community is, therefore, defined as one in which no one can be made better off without someone else becoming worse off.

The impossibility of quantifying economic welfare does not, however, in our view, mean that it is not important and can be ignored, any more than the quality of a good, which is also often unquantifiable, can be ignored in assessing its value. We believe that, although

2. For a detailed discussion, see Amartya Sen, 'Economic Development: Objectives and Obstacles', in Robert F. Dernberger (ed.), *China's Development Experience in Comparative Perspective*, Harvard University Press, Cambridge, Mass. (1981).

utility is not cardinally measurable, it is nevertheless possible to construct an ordinal ranking of the relative magnitude of utility which will accrue to different income groups by a given increment of their income; we assume that this magnitude will be higher for the low than for the high income groups. To take an extreme example, we maintain that the increase in welfare of a starving family from an additional income of, say, £10 per week used to finance its purchases of food would be larger than that of a rich family which spends an equal increment of income on buying, say, an extra bottle of champagne per week. This means that, to construct an index of growth of economic welfare, different weights should be attached to the rise in real income of the various income groups, the lower the income the bigger the weight. It also means that the consideration of income distribution must form an integral part of any acceptable index of economic development if it is agreed that the chief aim of development is to increase the economic welfare of the community as a whole.

This approach to economic welfare is in line with that of the nineteenth-century English utilitarians and of Alfred Marshall. The utilitarians believed that a transfer of income from the rich to the poor would generally increase the aggregate welfare of the community. And Marshall, the founder of the English neo-classical school of economics, specifically recognised that the utility derived from a given amount of additional income is greater for the low than for the high income groups. He writes, 'A shilling is the measure of less pleasure, or satisfaction of any kind, to a rich man than to a poor one . . . The clerk with £100 a year will walk to business in a much heavier rain than the clerk with £300 a year; for the cost of a ride by tram or omnibus measures a greater benefit to the poorer man than to the richer.'[3] It is clear that the refusal of some economists to recognise this fact, as well as their insistence on 'value-free' 'objective' comparisons of economic situations in adopting Pareto's concept of 'optimality', inevitably exert a bias towards the maintenance of the status quo in the distribution of wealth and income.

The process of growth

The rate of growth of national income of a developing country will vary directly with the rates at which its idle resources are brought into production and the productivity of such resources is increased. Economic resources of less developed countries (LDCs) can, like those

3. Alfred Marshall, *Principles of Economics*, Macmillan, eighth edition (1920), p. 19.

of developed countries, be divided into three broad categories – land (including water and minerals), labour and man-made means of production; for the sake of brevity we shall refer to the latter as 'capital equipment',[4] The two most striking characteristics of LDCs which distinguish them from developed countries and which largely account for their low per capita production, are the relatively 'low degree of the utilisation' and the 'inferior productivity' of their land and labour resources. The phenomenon of the underutilisation of these two resources is clearly observed in the presence of a high level of open and disguised unemployment,[5] of large areas of potentially arable uncultivated land and of unexploited water and mineral resources. Their inferior productivity is reflected in the relatively small yields of cultivated land and in a low per capita output of labour in urban occupations as compared with developed economies.

The principal explanation for the above two characteristics of LDCs is the inadequacy of their capital equipment in relation to the size of labour force and to the area of unused cultivable land, a defect that can be remedied only through investment in capital equipment. Another important explanation is to be found in the backward technology and in the relatively poor quality of a labour force lacking in technical, organisational, and administrative skills and suffering from poor health. To remedy this shortcoming too it is necessary to undertake investment in human resources through outlays on health, on education and on the introduction of new technical skills.

As we shall see, in many developing countries a number of institutional factors, such as archaic feudal and semi-feudal land tenure systems, also hamper the utilisation and productivity of land and labour resources. This type of obstacle to the growth of production, however, calls for political solutions with which we shall not be directly concerned.

Leaving aside the institutional factors, it is clear from the above that, 'the process of increasing the degree of utilisation and of improving the productivity of the available resources of a country' in development, entails the *creation* of additional productive resources through investment in capital equipment, in human resources and in production technology, including organisational skills. A large part of this book will be devoted to an examination of the ways and means in which

4. The term 'capital equipment' is thus used in this book to signify all man-made means of production, including economic infrastructure, e.g. transport and communication facilities.
5. For a discussion of the question of 'disguised unemployment', see Amartya Sen, *Employment, Technology and Development*, OUP (1975), Chapter 4.

fiscal and monetary policies can be used to encourage the *creation* of such additional productive resources through investment.

The relative size of physical productive capacity, or capital equipment, in industrial and developing countries goes a long way in explaining the fundamental difference between the crucial economic problems facing the two groups of economies. The capital equipment of industrial countries is adequate to provide employment for their entire labour force; the so-called 'structural unemployment', due to a lack of consistency, or harmony, between the patterns of production and demand, accounts for a relatively small fraction of their labour force. The levels of employment and production in these economies is determined primarily by aggregate effective demand; in Kalecki's terminology they are 'demand-determined'. Hence, the *crucial* long-term problem of free enterprise industrial countries is to avoid the loss of production that results from a deficiency in effective demand.

In developing countries, on the other hand, production is primarily constrained by a shortage of productive capacity in the form of capital equipment, noted above, rather than by a deficiency in effective demand; they can therefore be regarded as 'supply-determined'. They face a serious problem of 'structural unemployment', accounting for a significant proportion of the labour force, due largely to the shortage of capital equipment in relation to labour force. The *crucial* long-term problem of these countries is, therefore, the creation of additional productive capacity through investment. Compared with this, the problem of deficiency in effective demand, discussed in Chapter 6, is of *secondary* importance for LDCs, just as the problems of structural unemployment and production bottlenecks are for developed economies.

Economic welfare index

We shall generally measure economic welfare by reference to the standard of living of individuals, as reflected in the volume of their consumption. It is realised that this is a very narrow definition of economic welfare since it takes no account of many other important implications for welfare of economic development; these include the welfare resulting from employment, as distinct from income,[6] and various environmental and cultural features of development which enhance or diminish the welfare of the community. But we abstract

6. See Frances Stewart and Paul Streeten 'Conflicts Between Output and Employment Objectives in Developing Countries', *Oxford Economic Papers*, July 1971, and Amartya Sen, *Employment, Technology and Development*, Chapter 9.

from these and other problems involved in the assessment of welfare.[7] What we require is a concrete index which can be used in practice as a rough indicator of the rate of development and for this the level of consumption of individuals should generally be adequate.

Since the level of personal consumption is determined largely by real income, one can take changes in real income of individuals as indicators of changes in their economic welfare. It would follow from this that the rate of economic development for each individual can be assessed by reference to the rate of growth of his real income. But development policy should aim at increasing the welfare of the community as a whole; this embodies numerous individuals with different levels of income. To ascertain the rate of development of the economy, one requires an average *weighted index* of the growth in GNP, or real income, which in some way reflects the growth of welfare of the entire community.

It would be possible to obtain, as is at times done, a numerical measure of the weighted index of national income by assigning some arbitrary numerical weights to the income of different groups in the community. For example, if the population were divided into five income groups, one could start with a weight of 1 for the richest and end with a weight of 5 for the poorest group. The rate of progression of the weights should vary with the spread of income between the groups; the larger the spread, the steeper the progression. For example, in some developing countries, where members of the richest group are at least as opulent as those in industrial countries, and members of the poorest group live well below subsistence level, one could vary the weights from 1 for the former to say 20, 50, or even more for the latter group. There is, of course, no neutral 'scientific' way of determining these weights; they are arbitrary in the sense that they are decided, implicitly or explicitly, by the policy makers in accordance with their moral and political judgment.

There appears to be no special reason, however, for giving arbitrary numerical weights to different income groups; an ordinal ranking of weights should in practice generally be adequate. One could, for example, estimate a minimum level of acceptable income, or a 'poverty line', for each developing country, and proceed to give a top priority to raising the level of income of those groups that fall below the poverty line, and lower priorities to increasing the incomes of higher income groups; the higher the level of income of a group the lower its

7. Readers interested in this subject should refer to Amartya Sen, 'The Welfare Basis of Real Income Comparisons: A Survey', *Journal of Economic Literature*, March 1979.

priority. Although the poverty line can never be clearly and precisely defined, it is nevertheless possible to form a reasonable view of the order of magnitude of the minimum income required to prevent poverty. The reason for this is that the bulk of this income is required to defray the costs of the *minimum* amount of food, clothing, shelter and health services required to maintain an individual alive and in an active healthy condition, and this can be objectively estimated. The other less tangible human requirements, such as *minimum* education and recreation, which are not so easily assessable, account for only a relatively small fraction of the total consumption in developing countries and cannot significantly affect the level of the poverty line. The ILO and World Bank have, for example, made rough estimates of the poverty line for a large number of LDCs. According to these estimates about one-third of the population of developing countries in the mid-1970s was found to live below the poverty line and was designated as 'absolute poor'.[8]

No mention has thus far been made of the temporal aspect of economic development. Governments should be concerned not only with the welfare of the present generation but also with that of future generations. What is considered the best development policy for the present generation may not necessarily contribute most to the welfare of future generations. As explained in Chapter 2 (pp. 55–9), an acceleration in the rate of growth of production would entail an increase in the share of investment and a corresponding reduction in the share of consumption in national income. This will mean a restraint on the rate of growth of current consumption in the interest of increasing the productive capacity of consumer goods in the future.

Governments are thus compelled to apply, at least implicitly, some system of weighting the welfare of different generations in formulating their investment policies. The policy adopted is a matter of 'value judgment' on the part of the authorities, since there is no 'objective' way of comparing the welfare of different generations.[9] The theories which maintain that the rate of interest, in some way, indicates the community's preference for current consumption have little foundation in reality; they have, nevertheless, at times been used morally to justify interest accruing to wealth owners, as was done, for example, by Marshall. Although Keynes was able to demonstrate that interest was a reward for 'illiquidity' and not a reward for 'abstinence', these

8. See OECD, *Development Co-operation, 1978 Review*, p. 41 and Annex II. See also World Bank, *World Development Report, 1980*, p. 13 for more recent estimates.
9. See A.K. Sen, *Choice of Techniques*, second edition, Basil Blackwell, Oxford (1962), Chapter VIII and Appendix B.

theories continue to be used in one form or another in the current literature.[10]

Essential and inessential investment and consumer goods

In terms of the allocation of investment resources, the foregoing approach would of course entail giving a higher priority to the provision of goods and services required by the lower income groups, namely the majority of the population. For most developing countries this will involve a concentration of resources into production of food and clothing of the type consumed by lower income groups and into provision of low cost housing and simple health and education services needed to raise the standard of living of such groups. For some developing countries an even more urgent and important policy objective than the elimination of extreme poverty is the need to reduce the risk of periodic disasters resulting from droughts, floods, tidal waves, etc. The human suffering that results from these disasters – famine, sickness, epidemics, and so on – is considerably more acute than any experienced by living below the poverty line.[11]

Throughout this book the terms *essential investment* and investment with a *high social priority*, are used somewhat loosely to indicate the type of investment mentioned above, while the terms *inessential investment* and *low priority investment* signify the type which caters to the needs of the minority consisting of the richer members of the community. Similarly the expressions *essential consumer goods* and *necessities* are used to cover those goods and services which constitute the bulk of the consumption of the majority of the population, whereas *non-essentials* and *luxuries* refer to goods consumed mainly by the richer strata of the population.

It is clear that the two categories of investment and of consumer goods mentioned are not fixed in character; the list of 'essential investment' and of 'necessities' will vary from country to country and for the same country from one period to another. Generally, the higher the standard of living of the broad masses of the population, the larger will be the list of essential investment projects and of goods and services included in the category of necessities.

It is also clear that the suggested criteria for classifying investment

10. See Eprime Eshag, *From Marshall to Keynes, An Essay on the Monetary Theory of the Cambridge School*, Basil Blackwell, Oxford (1963), Appendix to Chapter III. See also J.M. Keynes, *The General Theory of Employment, Interest and Money*, Macmillan (1936), Chapters 13–14, especially pp. 174 and 182.
11. See Amartya Sen, in Robert F. Dernberger (ed.), *China's Development Experience*.

projects are too broad to permit the ranking of *all* investment projects in the order of their social priority. Although most projects can be so ranked without much difficulty, some are likely to be of the same order of importance for the promotion of economic welfare and should be grouped in the same rank. It would, for example, be difficult to distinguish between a project aimed at promoting the education of the majority of the population from one that aims at improving its health, and the policy makers will have simply to use their judgment in the allocation of resources between them. This is, however, a relatively minor problem, since investment decisions in such cases are unlikely to exercise an important influence on development. As explained in the following chapters, in practice, the policies which significantly influence the welfare index of development tend to be concerned with the distribution of resources between what are easily identifiable as being 'essential' and 'inessential' investment in terms of the broad criteria mentioned (see also pp. 54–5).

In theory, one should evaluate the increase in economic welfare corresponding to any growth in GNP by examining time series data on the distribution of income between different income groups; the larger the share of the lower income groups in any increment of national income, the larger would be the increase in economic welfare of the community. Unfortunately, hardly any developing countries possess such data and, because of this, we propose to evaluate the welfare aspect of development through an examination of the pattern of investment catering primarily to domestic rather than export markets for which more information is available.

It should be possible to obtain a broad indication of the welfare aspect of the development policy of a country by comparing the amount of its *per capita essential investment* with that of its *per capita inessential investment*. To calculate these per capita figures, each category of investment should be divided by the respective number of people which it is intended to serve. In other words, one would have to divide the value of essential investment by the majority of the population in the lower income groups and that of inessential investment by the remainder of the population.[12] A policy which pays due regard to the welfare aspect of development would ensure that the per capita essential investment is larger than that of inessential investment. Abstracting from any differences in incremental capital/output ratio

12. Investment outlays, such as those on epidemic and flood control projects, which benefit the entire population of a country or region, can, for this purpose, either be excluded from the calculation or be apportioned between the two classes of income groups in the ratio of their population.

(ICOR)[13] the higher is the ratio of per capita essential to per capita inessential investment, the larger will be the growth in economic welfare corresponding to any increase in national income.

Lop-sided development

It will be shown later that in many developing countries the criterion of promoting the economic welfare of the community plays a relatively small part in determining the pattern of investment as compared with other criteria, such as profitability and prestige value of investment. Consequently in many of these countries a relatively large share of investment tends to be devoted to the production of luxuries and to other low priority purposes. Although, for reasons noted above we refrain from resorting to a numerical index of economic welfare, we can still make qualitative distinctions between different types of investment policies, by reference to the ratio of per capita essential to per capita inessential investment. Since policies which attach some weight to the welfare index of development would ensure that the ratio in question is greater than unity, we shall designate as *lop-sided* any development in which this ratio is less than unity; the lower the ratio falls below unity, the greater the degree of 'lop-sidedness'.

STRATEGY OF DEVELOPMENT

According to the orthodox neo-classical theory the problem of development, like most important economic problems encountered by industrial countries, is best resolved by the market mechanism. The theory implies that market forces and competition, unhindered by government intervention, will, in the long run, tend to bring about the maximum rate of resource utilisation and a pattern of resource allocation which produce optimum social welfare, as defined by Pareto. This attitude to development continues to survive in the literature of economics and to influence government policies, although it would not be easy to find a single developing country that is prepared to consign its economic destiny entirely to the free operation of market forces.

It is argued here that economic development, as we understand it, requires active government participation in the management of the

13. The ratio of the increment in 'capital equipment' to the increment in 'productive capacity', which will equal the ratio of net investment to the increment in national income when productive capacity is fully utilised.